

For-profit school converted to nonprofit school. An otherwise qualifying nonprofit organization that purchases or leases at fair market value the assets of a former for-profit school and employs the former owners, who are not related to the current directors, at salaries commensurate with their responsibilities is operated exclusively for educational and charitable purposes. An organization that takes over a school's assets and its liabilities, which exceed the value of the assets and include notes owed to the former owners and current directors of the school, is serving the directors' private interests and is not operated exclusively for educational and charitable purposes.

Advice has been requested whether the nonprofit organizations described below, which otherwise qualify for exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954, are operated exclusively for charitable and educational purposes.

Situation 1.

X is the successor nonprofit organization to a former for-profit school. X purchased all of the for-profit school's personal property and leased the land and buildings from the former owners of the for-profit school. The personal property was purchased at fair market value and the rental of the leased facilities is at a fair market rental.

The former owners of the for-profit school are employed by X to reside at the school on a 24 hour basis and provide supervision and care of the students. The salaries paid to the former owners are commensurate with their responsibilities and are reasonable compensation for their services.

None of X's officers or directors is related by blood or marriage to the former owners, nor is any of them a business associate of the former owners.

Situation 2.

Y, a nonprofit organization, received all of the stock in a for-profit school as a gift. Y dissolved the for-profit school and assumed all of its liabilities, including notes owed to the former owners. The financial information indicates that the liabilities of the for-profit school exceeded the fair market value of its assets. Y's Board of Directors is composed of the former owners of the stock of the for-profit school.

Section 501(c)(3) of the Code provides for the exemption from Federal income tax of organizations organized and operated exclusively for charitable and educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(d)(1)(ii) of the Income Tax Regulations provides that an organization is not organized and operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, to meet this requirement, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

In Situation 1, X purchased the former school's personal property at fair market value in an arm's length transaction and is paying a fair rental value for the use of the land and buildings. X has also established that it pays the former owners of the for-profit school reasonable compensation for their services.

Accordingly, X has established that it is operated to serve a public rather than a private interest. Therefore, X is operated exclusively for educational and charitable purposes and qualifies for exemption from Federal income tax under section 501(c)(3) of the Code.

In Situation 2, however, the Directors of Y benefitted in their individual capacities from Y's acceptance of a transfer of the stock in the for-profit school and its assumption of all the pre-existing liabilities thereof in connection with its subsequent liquidation. Since these liabilities included the notes owed to such directors and the liabilities of the for-profit school exceeded the fair market value of its assets, the nonprofit school is substantially serving the directors' private interests in honoring them. The directors were, in fact, dealing with themselves and will benefit financially from the transaction. Therefore, Y is not operated exclusively for educational and charitable purposes and does not qualify for exemption from Federal income tax under section 501(c)(3) of the Code.

Even though an organization considers itself within the scope of Situation 1 of this Revenue Ruling, it must file an application on Form 1023, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(3) of the Code. The application should be filed with the District Director of Internal Revenue for the district in which is located the principal place of business or principal office of the organization. See sections 1.508-1(a) and 1.501(a)-1 of the regulations.